

Ontario Tax Studies

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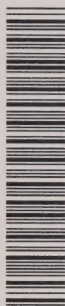
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Reassessing the Scope for Fiscal Policy in Canada




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Staff Paper

Ministry of Treasury, Economics and
Intergovernmental Affairs
Taxation and Fiscal Policy Branch





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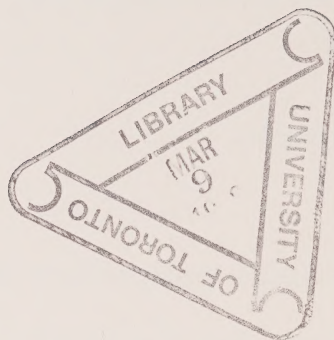
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Reassessing the Scope for Fiscal Policy in Canada

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Reassessing the Scope for Fiscal Policy in Canada

Introduction

The need for a modernized approach to fiscal policy in Canada, with greater recognition of the complexities of inter-regional linkages and the desirability of attaining a more appropriate balance between the private and public sectors, was acknowledged in the *1970 Ontario Budget*. This document presented a review of some of the major difficulties in the management of economic policy in Canada. It recognized the special problems of co-ordinating economic and fiscal policies in the framework of the Canadian federal system.¹ In the intervening years, the Province of Ontario has shared with the federal government and the other provinces the job of stabilizing fluctuations in employment, prices and incomes—a task which has not been without difficulty.

This paper focuses on four dimensions of fiscal policy:

- the current unemployment problem;
- the stabilization record of the 1970's;
- the full-employment budget position of Ontario and the Government of Canada; and,
- the regional impact of the Ontario budget.

During the 1970's, fiscal policies of Ontario and the federal government have generally been appropriately directed. Nonetheless, statistically high rates of unemployment have prevailed since 1975. A careful examination of the current job gap reveals that many of the unemployed are relatively inexperienced young people, and mature women who wish to divide their energies between managing a household and employment. Generalized fiscal stimulus may do little to improve the job prospects of these groups. To have a significant employment impact, measures must be selective and directed towards the groups and regions where the problem is most severe.

Ontario's full-employment budget analysis reveals that even with a return to full employment, both the Province and the federal government are locked into substantial deficits. It underscores the fact that the potential for self-financing macro-stabilization policies does not exist and that there is no fast, easy route to regaining full employment

¹See Hon. C. S. MacNaughton, "The Public Sector and Economic Policy", Budget Paper A, *1970 Ontario Budget* (Toronto: Department of Treasury and Economics, 1970); also in Hon. C. S. MacNaughton, *Ontario's Proposals for Fiscal Policy Co-ordination in Canada* (Toronto: Department of Treasury and Economics, 1970).

in Canada. Fundamental structural changes in the economy are required to enhance competitiveness, increase exports, and generate well-paying jobs.

This paper also examines the regional impact of Ontario's budget within the province. It shows that the Government has deployed its public resources to produce a more balanced pattern of economic growth and development among the province's economic regions. Further, it establishes that Ontario's regional development policies can be advanced within the overall fiscal context of a balanced budget.

I Assessing Economic Performance in 1977

In recognition of the changed economic conditions of the 1970's, Budget Paper A in the 1977 *Ontario Budget* raised the high-employment benchmark to 5.3 per cent for the purpose of estimating the Provincial full-employment budget. The changes in economic circumstances which suggested the need for the upward revision were fully documented in that Budget Paper.² They include changes in the demographic structure of the labour force, changes in worker preferences resulting from the higher Unemployment Insurance benefits, introduced with revisions to the Unemployment Insurance Act in 1971 and 1972, and a statistical adjustment for the broader coverage of the revised Labour Force Survey introduced in 1975. Subsequent analysis suggests that the comparable full-employment target for Canada is 5.6 per cent.³ These norms will gradually change in the future, reflecting demographic shifts, structural improvements to the economy and specifically directed actions by governments.

The re-appraisal of the unemployment level at which generalized fiscal and monetary policy is effective has been conducted independently by many groups in Canada and the United States. The Economic Council of Canada, in its *Thirteenth Annual Review* revised the full-employment norm to 4.5 per cent from 3.0 per cent for Canada.⁴ Noah Meltz and Frank Reid at the Centre for Industrial Relations of the University of Toronto concluded that in 1972, the unemployment rate shifted upwards by approximately 3 per cent.⁵ Jean-Michel Cousineau and Christopher Green, in a paper to the Canadian Economics Association, determined that the unemployment rate representing any given level of labour market tightness had increased about

²See the Hon. W. Darcy McKeough, "The Changing Character of Unemployment in Ontario", Budget Paper A, 1977 *Ontario Budget* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1977).

³Staff Paper *The Record of Fiscal Policy in Ontario and Canada* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, forthcoming).

⁴Economic Council of Canada, *Thirteenth Annual Review: The Inflation Dilemma* (Ottawa: Supply and Services, Canada, 1976), p. 118.

⁵Noah M. Meltz and Frank Reid, "The Recent Shift in the Canadian Unemployment-Vacancy Relationship and its Implications for Labour Market Policies", (Toronto: Working Paper of the Centre for Industrial Relations, University of Toronto, 1976).

2 per cent for 1972-1975 compared to the 1960's.⁶ The Ontario Economic Council, in the study *The Ontario Economy, 1978-87*, established 5.5 per cent unemployment as the norm for calculating potential output in Ontario.⁷

In the United States, full-employment output has been re-estimated by the Brookings Institution using an unemployment rate of 5.0 per cent, slightly above the 4.9 per cent rate used in the *1978 United States Budget*.⁸ Arthur Okun, of the Brookings Institution, has summarized the statistical analysis on full-employment norms thus:

"Serious statistical studies designed to estimate the unemployment rate associated with reasonably balanced—neither slack nor tight—labour markets converge on a range between 5.0 and 5.5 per cent."⁹

In the light of these conclusions, it is important to examine the actual performance of the labour market in 1977. In terms of employment growth, 1977 was a reasonably successful year. In Ontario, average employment grew by 73,000 jobs, or 2.0 per cent; December 1977 over December 1976 employment was up by 109,000 or 3 per cent. In Canada, average employment grew by 184,000 jobs, or 1.9 per cent. Despite this increase in jobs, the unemployment rate in Ontario rose from 6.2 per cent to 7.0 per cent, largely because of the increased participation of women and teenagers in the labour force. Seventy per cent of the new entrants to Ontario's labour force in 1977 were youths or females. This reflects the health of the labour market but it also means that new opportunities must be provided for these particular groups if total unemployment is to be significantly reduced.

In 1977, to reach Ontario's technical high-employment norm, an additional 68,000 jobs would have been required. By comparison, 200,000 jobs would have been required in the rest of Canada. The breakdown of this job gap by age and sex is presented in Table 1. Two important features stand out. First, about one-half of the jobs required to reach high employment would be needed for relatively inexperienced young people under 25 years of age. Jobs for youth is the major challenge both in Ontario and the rest of Canada. Second, the job gap for prime age males in Ontario is 14,000, or 21 per cent of the job gap total compared with 49,000, or 25 per cent in the rest of the country. This differential reflects the relatively more serious actual unemployment problem in the rest of Canada.

⁶Jean-Michel Cousineau and Christopher Green, "Causes of High Unemployment in Canada: 1970 to 1975", a paper presented at the annual meeting of the Canadian Economics Association, May, 1976.

⁷David K. Foot et al., *The Ontario Economy 1977-1987* (Toronto: Ontario Economic Council, 1977), p. 42.

⁸G. L. Perry, "Potential Output and Productivity", *Brookings Papers on Economic Activity*, 1: 1977 (Washington: Brookings Institution, 1977) and, President J. Carter, *1978 United States Budget* (Washington: United States Government Printing Office, 1978).

⁹Arthur M. Okun, "The Great Stagflation Swamp", *The Brookings Bulletin* (Washington: Brookings Institution, 1977), Vol. 14, No. 3, Fall 1977, p. 3.

Profile of 1977 Unemployment

Table 1

Ontario

	Actual Unemployment Rate	Actual Number Unemployed	Technical High Employment Rate	Additional Jobs Needed to Achieve High Employment
	(%)	(000)	(%)	(000)
Prime Age Males	3.9	61	3.0	14
Prime Age Females	7.1	68	5.7	13
Older Workers (55+)	4.1	20	3.1	5
Youth (15-24)	13.0	134	9.6	35
	7.0	282	5.3	68

Rest of Canada

	Actual Unemployment Rate	Actual Number Unemployed	Technical High Employment Rate	Additional Jobs Needed to Achieve High Employment
	(%)	(000)	(%)	(000)
Prime Age Males	5.6	146	3.7	49
Prime Age Females	8.2	115	5.1	44
Older Workers (55+)	5.0	37	3.5	11
Youth (15-24)	15.3	280	10.0	96
	8.8	580	5.8	200

Canada

	Actual Unemployment Rate	Actual Number Unemployed	Technical High Employment Rate	Additional Jobs Needed to Achieve High Employment
	(%)	(000)	(%)	(000)
Prime Age Males	5.0	207	3.5	63
Prime Age Females	7.8	183	5.4	57
Older Workers (55+)	4.7	57	3.3	16
Youth (15-24)	14.5	414	10.0	131
	8.1	862	5.6	268

Source: Statistics Canada, *The Labour Force*, Catalogue No. 71-001 and Ontario Treasury estimates.

Note: Figures may not add due to rounding.

Perspective on these unemployment figures may be gained by examining labour market performance during the years 1972 to 1974 when the Ontario economy became progressively more overheated and job growth boomed. In this period of high demand for labour, unemployment among prime age males in Ontario dropped to about 2.5 per cent, a level at which market forces generate inflationary wage

demands. In the same period, youth unemployment in Ontario did not fall below 8.0 per cent. Since then, the differential between income prospects from employment and from unemployment benefits for youth has narrowed, further reducing work incentives for this group.

Employment recovery above and beyond the high-employment level displayed in this Table can only be achieved through major structural changes to the economy. This fact underscores the need for measures designed to encourage private sector growth. Employment-creating programs must be selective, directed to groups most requiring assistance and consistent with longer run economic growth and stability.

II The Stabilization Record of the 1970's

The full-employment budget was introduced in the *1971 Ontario Budget* as an important additional tool for public sector management. Its purpose is to assist in the evaluation of the direction and magnitude of the Budget's fiscal impact on the economy. In order to place Provincial fiscal policy in perspective, a parallel assessment of federal fiscal policy in Canada is also carried out. Although the full-employment budget has been used in the United States since the 1960's, and in Ontario since 1971, it is not currently in use by the federal Department of Finance or by any other jurisdiction in Canada. However, full-employment budget estimates for Canada have been published by the Conference Board in Canada.¹⁰ Adoption of full-employment budgeting on a regional basis has been advocated by various groups; most recently by the Economic Council of Canada.¹¹

The full-employment budget technique of evaluating the performance of government fiscal policy involves the estimation of governments' revenues and expenditures within the context of attainment of potential full-employment output and employment. The value of the full-employment budget analysis lies chiefly in the distinction which it makes possible between discretionary and automatic changes in the public sector's economic impact. Comparisons of government deficits on a consistent, full-employment basis make possible an evaluation of the additional discretionary thrust provided by government after allowing for the change in deficits brought about by economic growth and automatic changes in revenues and expenditures. Net Fiscal Impact at full employment expressed as a percentage of potential output makes possible consistent comparisons through time and among jurisdictions.

¹⁰Robert B. Crozier, "Performance and Potential Perspectives on the Economy", *Canadian Business Review*, Spring 1977, Vol. IV, No. 2, p. 1; and, Robert B. Crozier, "The Federal Budget, March 31, 1977: Limits to Government Intervention", *Canadian Business Review*, Spring 1977, Vol. IV, No. 2, p. 10.

¹¹Report of the Economic Council of Canada, *Living Together: A Study of Regional Disparities* (Ottawa: Ministry of Supply and Services, 1977). See Recommendation 7, p. 223 in particular.

Using estimates of high-employment output as a benchmark, the economic fluctuations of the 1970's fall into five distinct phases: the 1970 and 1971 recession and recovery; virtual full-employment balance in 1972; overheating during 1973 and 1974; the recession of 1975; and, the years of recovery and adjustment in 1976 and 1977. Table 2 presents the magnitude of the gap between actual and potential output during these phases in Ontario and Canada. The figures suggest that Ontario experiences stronger and more rapid cyclical swings than Canada as a whole.

**Potential Output Gap,
Ontario and Canada**

Table 2

(per cent)

	Ontario Gap	Canada Gap	Ontario Gap as a Per Cent of Canada Gap
1971	-0.5	-1.8	11
1972	+0.9	-1.1	*
1973	+2.9	+2.1	55
1974	+1.8	+1.3	57
1975	-3.5	-3.2	44
1976	-1.9	-2.9	26
1977	-3.8	-5.6	28

Source: Potential output estimated from aggregate production functions.

Notes: 1. The production functions used incorporate the revised full-employment norms, 5.3 per cent for Ontario and 5.6 per cent for Canada.

2. The gap between potential output and actual output for Ontario and Canada is expressed as a percentage of potential.

*In 1972, the Canadian economy as a whole performed below potential, while the Ontario economy was at a level slightly above potential. The gap between potential and actual output for Canada excluding Ontario was 2.4 per cent.

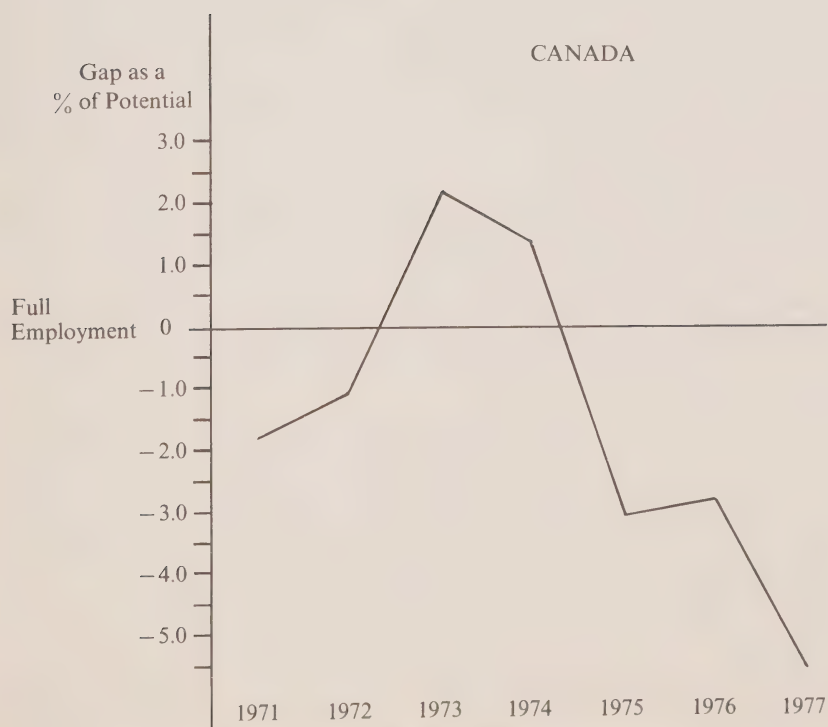
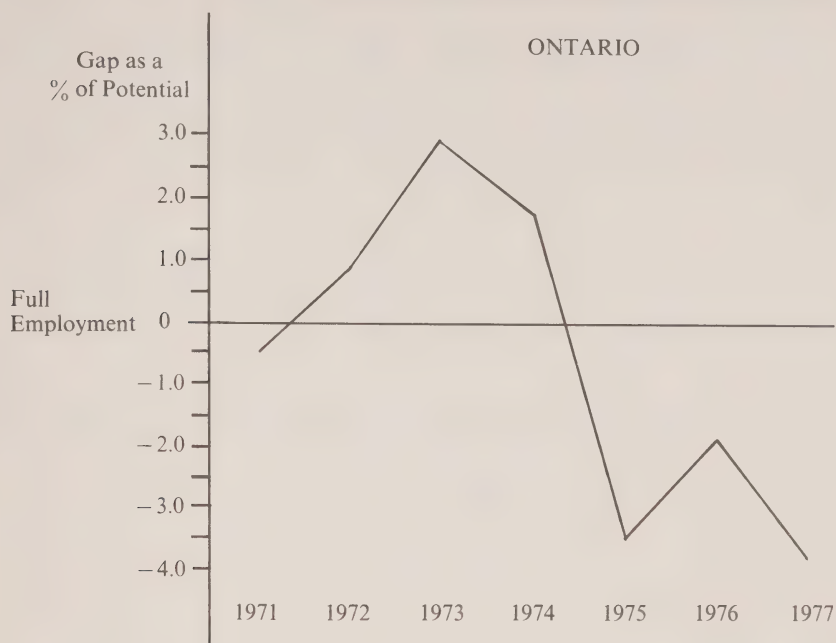
As Chart 1 illustrates, Ontario's economic performance leads that of Canada as a whole. That is to say, during periods of recovery, Ontario expands more rapidly than the rest of the country—such as in 1972—and during periods of economic recession, the slowdown hits Ontario first. Until 1976, Ontario's performance was pivotal, exhibiting stronger swings than the rest of Canada. However, when the recovery slowed in 1977, the national economy suffered a more serious setback than did Ontario. Forecasts for 1978 indicate Ontario will resume a lead position once more as growth accelerates.

The cyclical instability of the Canadian economy during the 1970's has been substantially moderated by discretionary actions of the federal and provincial governments.

In 1971, Ontario introduced a package of stimulative measures early in the year which provided a firm, expansionary reinforcement to the moderately expansionary stance of the *1970 Ontario Budget*. Federal policy, which had been contractionary in 1970, turned around gradually

Potential Output Gap, Ontario and Canada

Chart 1



in 1971 after Ontario measures had already begun to bite in. The federal personal income tax cut announced in October, 1971 was matched by Ontario and had effects which spilled over into 1972.

Table 3 displays estimates of the relative fiscal impact of the Ontario and federal budgets based on the revised full-employment budget norms. It shows that Ontario's expansionary thrust in 1971 was substantially greater than that of the federal government—about 1.25 per cent of potential GPP, compared to 0.63 per cent of potential GNP on the part of the federal government.¹²

In 1973 and 1974, both the Ontario and federal governments moved to more contractionary policies to offset the effects of overheating which had emerged in Ontario during 1972 and became pervasive throughout Canada in 1973.

The economic recession which began in the last part of 1974, precipitated by the shock of higher oil prices, hit with full force in the early months of 1975. The stimulative measures put in place by the federal Minister of Finance in November, 1974 began to take effect in 1975, and these were strengthened by further actions in the June federal budget. Table 3 shows that the expansionary fiscal actions of the federal government during 1975 amounted to 1.44 per cent of potential GNP—the strongest expansionary thrust throughout the 1970's and larger in relative terms than Ontario's actions during 1971. The 1975 *Ontario Budget* introduced special stimulative measures which were later reinforced in the July *Supplementary Actions*.¹³ These measures were designed to be immediate and temporary in effect, focused on sectors most needing support and directed at the expansion of basic productive capacity. Special measures included the temporary reduction in the retail sales tax from 7 to 5 per cent, terminating December 31; an exemption from retail sales tax for machinery and equipment; a \$1,500 grant to first-time home buyers and a temporary rebate of sales tax on new automobile purchases. The net fiscal impact of Ontario's stimulative actions amounted to 0.9 per cent of potential GPP. Action was focused on temporary tax cuts while efforts continued to bring government expenditures back into line with the long-run fiscal capacity of the Province.

¹²Bernard Jones and Jill Berringer, "Federal and Ontario Fiscal Policy in 1970 and 1971", *Ontario Economic Review* (Toronto: Department of Treasury and Economics, 1971) Nov.-Dec. Vol. 9, No. 6, p. 6; and, Hon. W. Darcy McKeough, "New Directions in Economic Policy Management", Budget Paper A, 1971 *Ontario Budget* (Toronto: Department of Treasury and Economics, 1971); and, Hon. W. Darcy McKeough, "Fiscal Policy Management in Ontario", Budget Paper A, 1972 *Ontario Budget* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1972).

¹³Hon. W. Darcy McKeough, 1975 *Ontario Budget* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1975); and, Hon. W. Darcy McKeough, *Supplementary Actions to the 1975 Ontario Budget* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1975); and, Hon. W. Darcy McKeough, "Economic Recovery", Budget Paper A, 1976 *Ontario Budget* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1976).

Indicators of Fiscal Policy Action
(\$ million)

Table 3

	1971	1972	1973	1974	1975	1976	1977
<i>Ontario Government</i>							
Net Fiscal Impact	(483)	(41)	95	48	(631)	257	816
Net Fiscal Impact as a % of Potential GPP	(1.25)	(.40)	.19	.08	(.91)	.33	.92
Output Gap (%)	-.5	+.9	+2.9	+1.8	-3.5	-1.9	-3.8
<i>Government of Canada</i>							
Net Fiscal Impact	(605)	(508)	13	774	(2,467)	1,084	(2,405)
Net Fiscal Impact as a % of Potential GNP	(.63)	(.48)	.01	.53	(1.44)	.55	(1.10)
Output Gap (%)	-1.8	-1.1	+2.1	+1.3	-3.2	-2.9	-5.6

Source: National Accounts and Ontario Treasury estimates.

Note: Bracketed figures indicate expansionary policy.

As Table 3 indicates, fiscal policy in Ontario and Canada was generally of the right direction until 1976. Most governments—including Canada and Ontario—anticipated a reasonable economic recovery in that year, and hence aimed their 1976 policies at closing widening deficits and adjusting to longer run financing realities. In actuality the recovery did not materialize, and in 1977 the federal government undertook renewed stimulus and pressed its capacity for expansionary actions to a new limit. This was accompanied by a further increase in unemployment, a clear demonstration of the reduced scope of generalized fiscal policy. The implications of changing realities on estimates of full-employment output, revenue and expenditure as well as the potential for fiscal action are discussed in the next section.

III Reassessing the Scope for Fiscal Policy

The prolonged inflation and the statistically high rates of unemployment experienced during the past several years have led to a careful examination of the changing structure of the Canadian and Ontario economies and of the extent to which fiscal policy actions can coincidentally fight inflation and reduce unemployment. The question of how much extra stimulus governments can afford, and the degree to which higher levels of stimulus are self-financing for governments through revenue and expenditure feedbacks must be addressed.

The basic shift in the unemployment-vacancy relationship observed in Ontario and Canada in the 1970's has led to a reconsideration of the traditional measures of labour market tightness at full employment. Using the new full-employment norms, more reliable estimates of potential output in Ontario and Canada have been derived. Full-employment budget performance is calculated using two variables: the

increase in government revenues as the economy reaches potential, and, the savings in Unemployment Insurance benefits as the unemployed find work.

The full-employment budget position of the Ontario and federal governments is displayed in Table 4. On this traditional basis, Ontario has been in full-employment deficit since 1971. Canada, by comparison, has had a surplus at full employment as recently as 1974. However, the full-employment deficit experienced by the federal government in 1977 is now almost double its level of 1975. These estimates are one measure of the current level of under-financing of government in Ontario and Canada.

**Full-Employment Budget Position,
National Accounts Basis**
(\$ million)

Table 4

	1971	1972	1973	1974	1975	1976	1977
Ontario Government	(359)	(442)	(410)	(451)	(1,158)	(1,059)	(369)
Federal Government in Canada	290	(188)	(205)	527	(1,852)	(1,029)	(3,564)

Source: National Accounts and Ontario Treasury estimates.

Note: Bracketed figures refer to deficits at full employment.

Since the early 1970's, Ontario and the other provinces have suffered from a shortfall in revenues resulting from their relatively inelastic revenue structure.¹⁴ The federal government, on the other hand, enjoyed rapidly expanding revenues in the early 1970's, which led to a habit of overspending. This problem of overspending was compounded by the introduction of all-pervasive indexing of social payments, which created large automatic increases in federal spending each year. Then, in 1974, the personal income tax was indexed against inflation, further aggravating provincial fiscal deficiency but also dramatically reducing federal revenue yields. As a consequence, the Government of Canada is now also experiencing a situation of fundamental underfinancing.

In the United States, by contrast, expenditure indexing is not nearly as extensive nor is the national income tax indexed against inflation. Consequently, the U.S. Budget is still framed in the context of full-employment "surpluses" and discusses tax cuts and expenditure increases to offset fiscal drag.¹⁵

This fiscal imbalance at both the federal and provincial level will continue to exist even with the economy performing at full employment, emphatically pointing to the need for restoring expenditure control

¹⁴See the Hon. John White, "Ontario's Revenue Structure", Budget Paper B, 1973 *Ontario Budget* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1973).

¹⁵Statement of Alice M. Rivlin, Director, Congressional Budget Office, before the Joint Economic Committee, December 5, 1977.

in the public sector. This return to fiscal integrity of the public sector in Canada is a prerequisite for economic growth and stability in the longer term.

An Alternative Measure of the Full-Employment Budget

The conventional estimates for the full-employment budget position of Ontario and Canada are shown in detail in Appendix 1. These estimates display the revenue and expenditure feedbacks which could be accomplished using the revised full-employment norms. For example, they show that if 68,000 more jobs had existed in Ontario in 1977, extra revenues to the Province would have amounted to \$380 million. This conventional analysis assumes that additional workers would receive average wages, pay average levels of tax and generate associated incomes commensurate with the normal share of wage income in GNP. This assumption is appropriate in a situation where mature workers with developed skills and long-term career commitments constitute the majority of the unemployed; as they return to work, productivity gains may be expected and at least average levels of remuneration are warranted.

In actuality, young people comprised 48 per cent of the unemployment in Ontario and Canada in 1977. This group, on the whole, has gained limited experience and skill. It cherishes its independence and capacity to explore job options in search of a challenging longer term career commitment. Moreover, many of the women who are unemployed choose to divide their energies between part-time jobs and managing a household. The contribution of this group to the labour force is derived from portable skills rather than from investment in learning-by-doing associated with more particularized skills related to the trades and professions. As these two groups join the employed labour force today, they generally command substantially lower wages than the average for the economy as a whole. Accordingly, their contribution to full-employment output is likely to be somewhat less than the average for the work force as a whole.

Given this realistic appraisal of the unemployed components of the labour force, an alternative way of measuring the impact of higher employment on government deficits is indicated. The alternative method outlined below assumes that these 68,000 additional workers would command wages which are competitive for their skills. Thus, in 1977, mature males are expected to command about the average weekly wage for Ontario. Women and older workers are expected to command a wage somewhat below the average in the service sector. Youth are expected to receive just over \$3.00 an hour, or \$125 a week. These wages are consistent with the experience in the 1970's with the most rapid employment growth in the low-wage service sector. Throughout the 1970's in Ontario, there has been relatively slower employment

growth in the higher wage manufacturing sector and virtually stagnant employment in the resource sector. The extra disposable income received as this group obtains jobs is the difference between aftertax income and aftertax Unemployment Insurance benefits. The expected increase in disposable income as individuals obtain full-time jobs is shown in Table 5. For mature males, the increase in disposable income on an annual basis amounts to \$4,443. By contrast, for youth, the increase in disposable income is about \$1,320.

**Contribution to the Economy:
Working vs Unemployed**
(dollars)

Table 5

Disposable Income per person	Working	Unemployed	Difference
Prime Age Males	10,253	5,810	4,443
Prime Age Females	6,449	4,381	2,068
Older Workers (55+)	6,449	4,381	2,068
Youth (15-24)	5,701	4,381	1,320
Direct Tax Feedback per person			
Prime Age Males	2,747	480	2,267
Prime Age Females	1,091	169	922
Older Workers (55+)	1,091	169	922
Youth (15-24)	799	169	630

Note: Males are assumed to receive about the 1977 average Ontario weekly wage of \$250 per week. Women and those 55 years of age and over are assumed to receive slightly below the average wage in the service sector, \$145 per week and youth to receive the going wage for individuals without special skills, \$125 per week. Unemployment benefits are about the average for Ontario in 1977.

The direct tax feedback to government accomplished through the switch from unemployment benefits to job income is also displayed in Table 5. This shows that for prime age males the income tax payable from 50 weeks of Unemployment Insurance benefits is \$480. This compares with a total of \$2,747 deducted from employment income for personal income tax, CPP and UIC premiums. The difference in revenue to government is \$2,267. For prime age females and older workers this drops to \$922. For young people between 15 and 24 years of age this tax difference is only \$630.

Based on this alternative method, employment at competitive wages for 68,000 people in 1977 in Ontario would yield an increase in Gross Provincial Product of \$333 million, of which \$152 million is an increase in disposable income for the previously unemployed. As Table 6 shows, the Government of Ontario could expect tax feedback of \$38 million in revenues associated with this increase in GPP at the higher level of employment. This includes Provincial income tax revenue as well as the feedback in other taxes. Reduced spending on Family Benefits and General Welfare Assistance payments would be minimal.

**Alternative Full-Employment
Budget Estimates for 1977**
(\$ million)

Table 6

	Traditional Estimate	Alternative Estimate	Change
<i>Ontario Government</i>			
National Accounts (Deficit)	(765)	(765)	—
Revenue Increase (+)	+ 384	+ 38	— 346
Expenditure Decrease (+)	+ 12	—	— 12
Full-Employment (Deficit)	(369)	(727)	— 358
<i>Government of Canada</i>			
National Accounts (Deficit)	(6,944)	(6,944)	—
Revenue Increase (+)	+ 2,235	+ 353	— 1,882
Expenditure Decrease (+)	+ 1,145	+ 1,247	+ 102
Full-Employment (Deficit)	(3,564)	(5,344)	— 1,780

Source: Ontario Treasury estimates.

Note: This overstates slightly the saving to the federal government from lower Unemployment Insurance benefits. In 1977, the federal government was responsible for paying all claims for unemployment above 5.9% in addition to the long-term claims. If unemployment fell below 5.9%, the extra revenue would remain in the UIC fund to go toward a premium reduction the following year.

Family Benefits recipients are, for the most part, permanently out of the labour force, and recipients of Unemployment Insurance benefits are likely to obtain employment in advance of those receiving General Welfare Assistance. Apart from corporate income tax due in the following year, any greater feedback would have to come from inflationary wage and price gains.

This estimate of the revenue feedback to Ontario with 68,000 extra employed persons in 1977 yields a full-employment deficit for Ontario of \$727 million, compared to \$369 million under the conventional full-employment analysis—an increase of \$358 million.

By contrast, the Government of Canada would not only receive a proportionately larger tax feedback than Ontario, it would also enjoy large savings in UIC payments if an extra 268,000 jobs had been created in Canada during 1977. The creation of these extra jobs at wage levels identical to those assumed for Ontario would generate an increase of \$1,386 million in Gross National Product, of which \$632 million represents an increase in disposable income. Extra federal tax revenues of \$353 million would be generated. And the savings on Unemployment Insurance benefits would amount to \$1,247 million. In conventional terms, the full-employment deficit of the Government of Canada was \$3,564 million in 1977. Under this alternative measure it rises to \$5,344 million.

The two methods of examining the budget position of governments at full employment presented here should be interpreted as providing

upper and lower limits of estimates. Export-led growth with a recovery in demand for resources and manufactures, accompanied by productivity gains and a recovery in profits could lead to a performance closer to that measured by the conventional analysis. By contrast, the marginal analysis developed here is consistent with an improvement in consumer confidence and a reduction in personal savings sufficient to generate the assumed increase in consumption and employment while maintaining stable wages and prices.

Both estimates of the full-employment budget position demonstrate that the governments of Ontario and Canada are locked into large deficits even at high levels of employment. Thus additional stimulatory measures will add to these deficits. Most of the improvement of the budget position of the public sector as full employment is reached comes from savings in Unemployment Insurance benefits, not from revenue increases. It shows that the capacity for automatic recovery of revenues or of self-financing fiscal stimulation is substantially less than is generally assumed.

IV Regional Impact of Ontario's Budget

In addition to assuring overall growth and stability, the Ontario Government has the responsibility to ensure a fair distribution of economic growth and public resources among regions within the province.

To illustrate the significance of the regional impact of Ontario's budget, and to explore its redistributive character, a path-breaking study of the flows of Ontario Government funds among regions within the province has been undertaken.¹⁶ Ontario has established five broad economic planning regions in the province which are shown on the map in Appendix 1. These areas provide the boundaries within which the regional allocation is conducted for this study. The study is based on data for three fiscal years—1972-73, 1974-75 and 1976-77, to assess the regional pattern of Ontario's budget impact over time.¹⁷

In the analysis used here, Provincial Government accounts are examined to determine where expenditures are made and where revenues

¹⁶In the 1977 *Ontario Budget*, a pioneering effort was made to determine the extent to which fiscal redistribution occurs among the provinces of Canada. See Hon. W. Darcy McKeough, "Federal Fiscal Redistribution within Canada", Budget Paper E, 1977 *Ontario Budget* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1977).

¹⁷For the purposes of this paper, only the budgetary account of the Provincial Government is analyzed. The non-budgetary account is not included for the following reasons. Investment and lending activities are multi-year oriented. Extraordinarily large loans and investments are made in specific years and recovery occurs over a long period of time. The five-year time frame of the study is too short to avoid distortion of the regional pattern of non-budgetary loans and recoveries. The conceptual framework used is the output-production approach which focuses on the location of the income and employment generation effects of the budget.

are collected. On the revenue side, there is little explicit regional accounting information available. To overcome this handicap, the various revenue sources are distributed according to indicators which reflect the respective revenue-generating capacity of each region. Examples of these indicators include personal income, dollar volume of liquor sales, value of mineral output, population by age group, and number of telephones. In most cases, expenditures can be allocated according to established accounting data. All regional revenues and expenditures are calculated on a per capita basis to neutralize the effects of differing populations among regions and of growing populations over time.

Regional revenue and expenditure distributions are combined to determine the net flows among regions.

Table 7 displays the net flows among planning regions in 1972-73, 1974-75 and 1976-77. A more detailed breakdown by major revenue and expenditure components is displayed in Appendix 2.

Regional Distribution of Ontario's Budget Table 7
(dollars per capita)

	North-west	North-east	East	Central	South-west	All Ontario
<i>1972-73</i>						
Total Revenue	856	760	746	792	719	774
Total Expenditure	922	928	821	812	811	825
Net Flows	66	168	75	20	92	51
<i>1974-75</i>						
Total Revenue	1,205	1,182	947	1,027	930	1,017
Total Expenditure	1,322	1,248	1,215	1,057	1,030	1,096
Net Flows	117	66	268	30	100	79
<i>1976-77</i>						
Total Revenue	1,338	1,292	1,187	1,310	1,174	1,272
Total Expenditure	1,819	1,630	1,525	1,381	1,311	1,420
Net Flows	481	338	338	71	137	148

Source: Ontario Treasury estimates.

An examination of the net financial flows reveals some significant patterns. In all three years, there are no implicit flows from one region to another; that is, no region generates greater revenues than it receives in expenditures. The Province finances the full difference in every region through deficit financing.

In the Northern regions, above average mining profits taxes, royalties, fuel taxes and LCBO profits are primarily responsible for the high tax yields. In Central and Southwestern Ontario, above average yields in the base taxes—personal income tax, corporation taxes and retail sales tax—are evident. This is to be expected given the

mature, diversified economic structure of these regions. The revenue yields in Central and Southwestern Ontario have grown more rapidly than those of the North between 1972-73 and 1976-77. The shift toward relatively greater revenue generation in the Southern regions is expected to be even more evident in 1977-78 and ensuing years due to the replacement of some federal transfers with personal income tax points and the \$10 vehicle registration fee for the North.

A significant part of the expenditure flow toward the North and the East results from the Regional Priority Budget. Created in 1973 by Cabinet authorization, the Regional Priority Budget provides financing for projects with high regional significance or urgency, over and above the normal ministerial budgets. Under the Regional Priority Budget, the Government of Ontario has implemented a large number of diversified projects. Since 1973, approximately 75 per cent of the Regional Priority Budget has been spent in Northwestern Ontario with 18 per cent in Eastern Ontario. These programs have played a significant role in improving the economic potential of these regions.

Regular ministry budgets also have a regional bias. For example, the formula which determines unconditional grants to municipalities incorporates the "Special Support Grant for Northern Municipalities". The Ministry of Northern Affairs, created in 1977, will also have a strong impact on the development of the Northern regions.

As a result of regionally oriented changes on both the revenue and expenditure accounts, there has been a substantial shift in the pattern of net financial flows. In 1972-73, the net fiscal input into the Northwest and East was slightly above the provincial average, that going to the Northeast was about three times the average for the province. By 1976-77, the net fiscal input to the Northwest was at least three times greater than the provincial average and the input to the East and Northeast exceeded twice the average for the province as a whole.

The Province is now working towards a balanced budget target by 1981. There may be some concern about the effect of a balanced budget on the distribution of public resources. It is not possible to say with certainty what the distributional effects of a balanced budget will be. However, to gain a preliminary perspective, a neutral adjustment is made on the revenue side to generate a balanced budget scenario. All revenues are raised by an equal proportion to equate revenues with expenditures.

Table 8 shows the revised distribution for 1976-77 under a balanced budget scenario. These figures suggest that even in a balanced position, the Ontario Budget will continue to have a strong regional influence. Southwestern Ontario, a region with a large farming community and a relatively high standard of living, is about at par. There are implicit flows from Central Ontario, with its well-developed economy. And there continues to be a net fiscal input into the less-developed regions of the province, the North and the East.

Regional Distribution Under a Balanced Budget Scenario, 1976-77

Table 8

(dollars per capita)

	North-west	North-east	East	Central	South-west	All Ontario
Total Revenue	1,493	1,442	1,325	1,462	1,310	1,420
Total Expenditure	1,819	1,630	1,525	1,381	1,311	1,420
Net Flows	326	188	200	-81	1	0

Source: Ontario Treasury estimates.

Notes: 1. In this table, revenue figures are increased to produce the effect of a balanced budget. All revenue sources are raised in proportion to their relative importance in the budget.

2. A negative sign indicates revenue is greater than expenditure.

Conclusion

This paper represents a contribution to the process of developing an appropriate strategy to assist the future growth and development of the Ontario and Canadian economies. To reiterate, the principal conclusions of this paper include the following points:

- The task of short-term economic stabilization in Canada during the 1970's has proved to be challenging and difficult. The findings documented in this paper demonstrate that there is no fast, easy route to regain full employment in Canada.
- The full-employment budget analysis demonstrates that even with a return to full employment both the Province and the federal government are locked into substantial budget deficits.
- The potential for self-financing macro-stabilization policies such as the Kennedy tax cut of the early 1960's no longer exists in Canada. The fiscal feedback to government from increased employment is largely in the form of UIC savings rather than revenue dividends.
- The composition of unemployment in Ontario and the rest of Canada merits more attention. Skilled, permanent jobs for youth is highlighted as the preeminent challenge to governments in the immediate future. Required are fundamental structural changes in the economy, to enhance competitiveness, increase exports, and generate well-paying jobs in the private sector.
- During the 1970's the Ontario Government has worked to redistribute public resources among the economic regions of the province. This paper establishes that even in a balanced position, the Ontario Budget can continue to ensure a fair distribution of economic growth and development throughout the province.

Appendix 1

Ontario Government Full-Employment Budget Estimates—Traditional Basis

Table 1-1

(\$ million)

	1971	1972	1973	1974	1975	1976	1977
National Accounts							
Surplus or (Deficit)	(380)	(399)	(246)	(327)	(1,408)	(1,214)	(765)
Revenue Increase (+)	+20	-42	-159	-119	+244	+148	+384
Expenditure Decrease (+)	+1	-1	-5	-5	+6	+7	+12
Full-Employment							
Surplus or (Deficit)	(359)	(442)	(410)	(451)	(1,158)	(1,059)	(369)

Source: National Accounts and Ontario Treasury estimates.

Government of Canada Full-Employment Budget Estimates—Traditional Basis

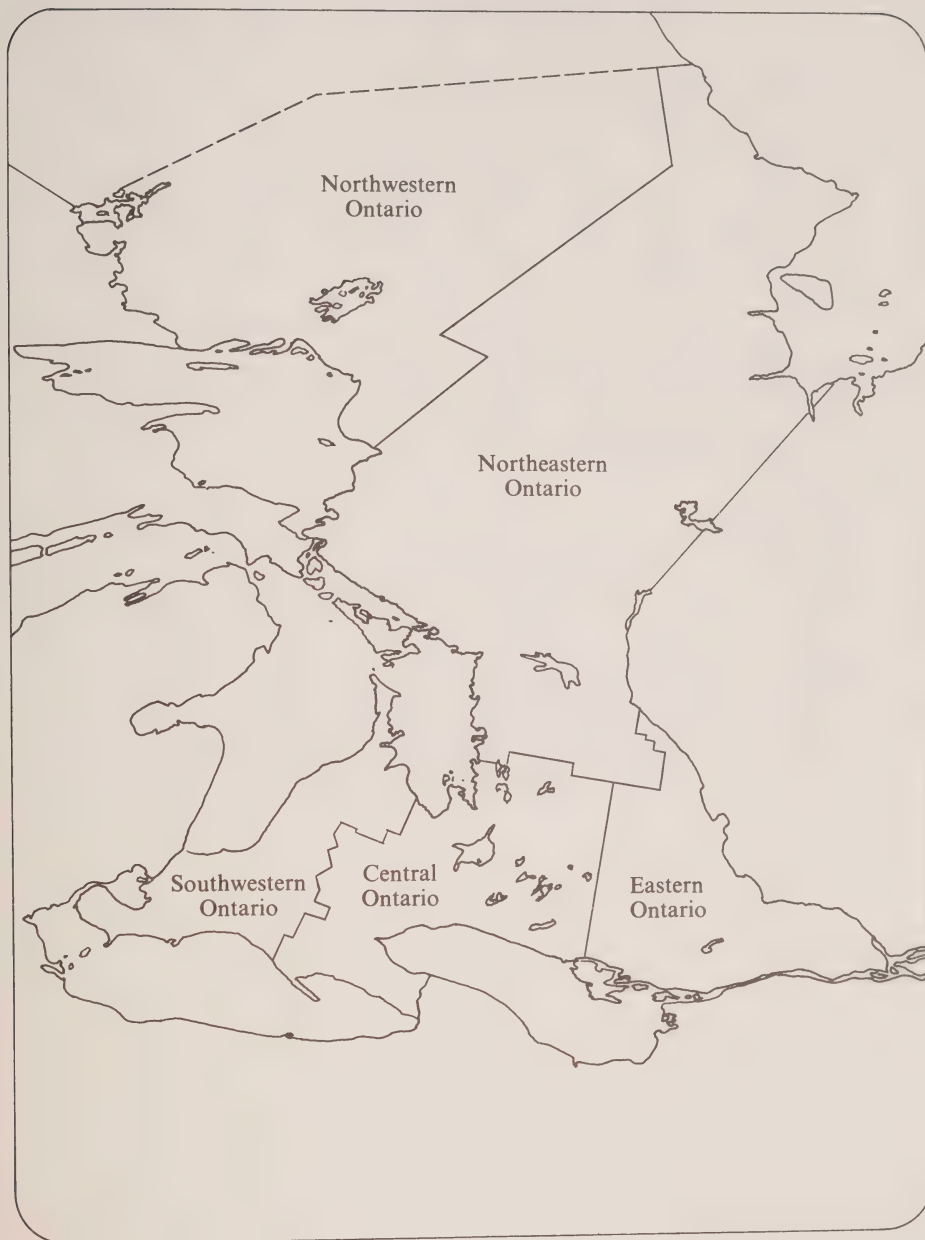
Table 1-2

(\$ million)

	1971	1972	1973	1974	1975	1976	1977
National Accounts							
Surplus or (Deficit)	(145)	(566)	387	1,083	(3,551)	(2,879)	(6,944)
Revenue Increase (+)	+352	+229	-520	-399	+1,121	+1,160	+2,235
Expenditure Decrease (+)	+83	+149	-72	-157	-578	+690	+1,145
Full-Employment							
Surplus or (Deficit)	290	(188)	(205)	527	(1,852)	(1,029)	(3,564)

Source: National Accounts and Ontario Treasury estimates.

The Economic Regions of Ontario



Appendix 2

Financial Flows Among Ontario's Regions, 1972-73 Table 2-1
(dollars per capita)

	North- west	North- east	East	Central	South- west	All Ontario
<i>Distribution of Revenue</i>						
Personal Income Tax	133	118	150	166	134	154
Corporation Taxes	52	55	45	76	68	67
Resource Taxes	45	38	5	1	0	5
Fuel Taxes	137	137	70	50	55	62
Retail Sales Tax	95	81	105	124	106	115
Liquor Related Revenues	49	37	36	32	25	33
All Other Revenues*	345	294	335	343	331	338
Total	856	760	746	792	719	774
<i>Distribution of Expenditure</i>						
Salaries and Benefits	179	139	96	103	88	104
Direct Operating Expenditures	63	61	42	48	37	47
Acquisition and Construction	43	39	30	28	28	30
Transfers	593	653	601	578	610	592
Net Public Debt	46	36	52	54	48	51
Other Expenditures	1	1	1	1	1	1
Total	925	928	821	812	811	825
Net Flows	66	168	75	20	92	51

Source: Ontario Treasury estimates.

Note: Figures may not add due to rounding.

*The category 'all other revenues' is comprised of major revenue sources such as OHIP premiums, federal government transfer payments, tobacco tax, motor vehicle licence fees and a number of smaller revenue sources. These sources show little regional variation.

Financial Flows Among Ontario's Regions, 1974-75 Table 2-2
(dollars per capita)

	North- west	North- east	East	Central	South- west	All Ontario
<i>Distribution of Revenue</i>						
Personal Income Tax	167	139	181	198	163	185
Corporation Taxes	99	103	74	122	112	112
Resource Taxes	171	232	6	1	1	23
Fuel Taxes	158	158	80	57	67	71
Retail Sales Tax	164	145	171	210	186	195
Liquor Related Revenues	54	42	40	40	25	38
All Other Revenues*	392	363	395	399	376	393
Total	1,205	1,182	947	1,027	930	1,017
<i>Distribution of Expenditure</i>						
Salaries and Benefits	215	168	123	128	115	131
Direct Operating Expenditures	135	87	72	63	55	67
Acquisition and Construction	71	48	41	48	34	46
Transfers	834	882	905	741	755	779
Net Public Debt	67	62	73	76	70	73
Other Expenditures	1	1	1	1	1	1
Total	1,322	1,248	1,215	1,057	1,030	1,096
Net Flows	117	66	268	30	100	79

Source: Ontario Treasury estimates.

Note: Figures may not add due to rounding.

*The category 'all other revenues' is comprised of major revenue sources such as OHIP premiums, federal government transfer payments, tobacco tax, motor vehicle licence fees and a number of smaller revenue sources. These sources show little regional variation.

Financial Flows Among Ontario's Regions, 1976-77 Table 2-3
(dollars per capita)

	North- west	North- east	East	Central	South- west	All Ontario
<i>Distribution of Revenue</i>						
Personal Income Tax	228	197	243	287	216	262
Corporation Taxes	122	127	88	145	141	134
Resource Taxes	40	93	8	2	2	5
Fuel Taxes	159	159	79	57	64	71
Retail Sales Tax	183	170	187	230	205	215
Liquor Related Revenues	69	48	52	46	43	45
All Other Revenues*	537	498	530	543	503	540
Total	1,338	1,292	1,187	1,310	1,174	1,272
<i>Distribution of Expenditure</i>						
Salaries and Benefits	293	227	145	176	139	173
Direct Operating Expenditures	102	89	66	65	54	66
Acquisition and Construction	129	64	31	32	32	37
Transfers	1,193	1,156	1,168	989	982	1,030
Net Public Debt	95	87	109	113	98	108
Other Expenditures	6	6	6	6	6	6
Total	1,819	1,630	1,525	1,381	1,311	1,420
Net Flows	481	338	338	71	137	148

Source: Ontario Treasury estimates.

Note: Figures may not add due to rounding.

*The category 'all other revenues' is comprised of major revenue sources such as OHIP premiums, federal government transfer payments, tobacco tax, motor vehicle licence fees, lottery profits and a number of smaller revenue sources. These sources show little regional variation.

